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REPORT FROM THE COMMISSION

CONVERGENCE REPORT 2008

(prepared in accordance with Article 122(2) of the Treaty)

{SEC(2008) 567}

1. PURPOSE OF THE REPORT

Article 122(2) of the Treaty requires the Commission and the ECB to report to the Council, at least once every two years, or at the request of a Member State with a derogation, on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union.

The latest Commission and ECB regular Convergence Reports were adopted in December 2006[1]. Denmark and the United Kingdom have not expressed their wish to adopt the single currency. Therefore, this convergence assessment covers the following ten Member States with a derogation: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden. Having joined the EU on 1 January 2007, Bulgaria and Romania are examined for the first time. A more detailed assessment of the state of convergence in the ten countries is provided in a Technical Annex to this report (SEC(2008) 567). In parallel, on 4 April 2008 Slovakia submitted a request for an assessment of the fulfilment of the necessary conditions to adopt the euro on 1 January 2009.

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires the reports to include an examination of the compatibility of national legislation, including the statutes of its national central bank, with Articles 108 and 109 of the Treaty and the Statute of the ESCB and of the ECB (henceforth ESCB/ECB Statute). The reports must also examine whether a high degree of sustainable convergence has been achieved in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, government budgetary position, exchange rate stability, long-term interest rates), and by taking account of several other factors mentioned in the final sub-paragraph of Article 121(1). The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

The examination of the compatibility of national legislation, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute requires an assessment of compliance with the prohibition of monetary financing (Article 101 EC) and the prohibition of privileged access (Article 102 EC); consistency with the ESCB's objectives (Article 105(1) EC); central bank independence (Article 108 EC); and integration of national central banks into the ESCB (several EC Treaty and ESCB/ECB Statute articles).

The ***price stability criterion*** is defined in the first indent of Article 121(1) of the Treaty: *"the achievement of a high degree of price stability […] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability"*.

1 In 2007, the Commission and the ECB prepared Convergence Reports on Cyprus and Malta, following the request of the national authorities. Cyprus and Malta adopted the euro on 1 January 2008.

Article 1 of the Protocol on the convergence criteria further stipulates that *"the criterion on price stability […] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions"*[2]. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors underlying inflation and of medium-term prospects. It also assesses whether the country is likely to meet the reference value in the months ahead[3].

The inflation reference value was calculated to be 3.2% in March 2008[4], with Malta, the Netherlands and Denmark as the three best-performing Member States.

The convergence criterion dealing with the ***government budgetary position*** is defined in the second indent of Article 121(1) of the Treaty as *"the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6)"*. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that *"at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists"*.

The Treaty refers to the ***exchange rate criterion*** in the third indent of Article 121 as *"the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State"*.

Article 3 of the Protocol on the convergence criteria stipulates: *"The criterion on participation in the exchange rate mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central*

2 For the purpose of the criterion on price stability, inflation is measured by the Harmonised Index of Consumer Prices (HICP) defined in Council Regulation (EC) No 2494/95, amended by Regulation (EC) No 1882/2003 of the European Parliament and the Council.

3 All the forecasts for inflation and other variables in the current report are from the Commission services' Spring 2008 Forecast. The Commission services' forecasts are based on a set of common assumptions for external variables and on a no-policy change assumption while taking into consideration measures that are known in sufficient detail. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

4 The cut-off date for the data used in this report is 18 April 2008.

rate against any other Member State's currency on its own initiative for the same period"[5].

The relevant two-year period for assessing exchange rate stability in this report is 19 April 2006 to 18 April 2008.

The fourth indent of Article 121(1) of the Treaty requires *"the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the* ***long-term interest rate levels****"*. Article 4 of the Protocol on the convergence criteria further stipulates that *"the criterion on the convergence of interest rates (…) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions"*.

The interest rate reference value was calculated to be 6.5% in March 2008.

Article 121 of the Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account[6] and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability.

2. BULGARIA

Bulgaria joined the European Union on 1 January 2007. In this report, the compatibility of its legislation with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute and its progress towards the achievement of sustainable economic convergence are therefore assessed for the first time.

The legal basis for the Bulgarian National Bank (BNB) is the Law on the BNB of 5 June 1997. The latest amendments were made in June and July 2007. As regards central bank integration into the ESCB at the time of euro adoption, legislation in Bulgaria, in particular the Law on the BNB, is not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. Imperfections subsist as regards banknotes and coins issues, the promotion of the smooth operation of payment systems, the ECB's approval before participation in international monetary institutions, the statistical role of the ECB and the EU, auditing by independent external auditors, institutional and personal independence as well as the prohibition of monetary financing.

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[5] In assessing compliance with the exchange rate criterion, the Commission examines whether the exchange rate has remained close to the ERM II central rate, while reasons for an appreciation may be taken into account, in accordance with the *Common Statement on Acceding Countries and ERM2* by the Informal ECOFIN Council, Athens, 5 April 2003.

[6] The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

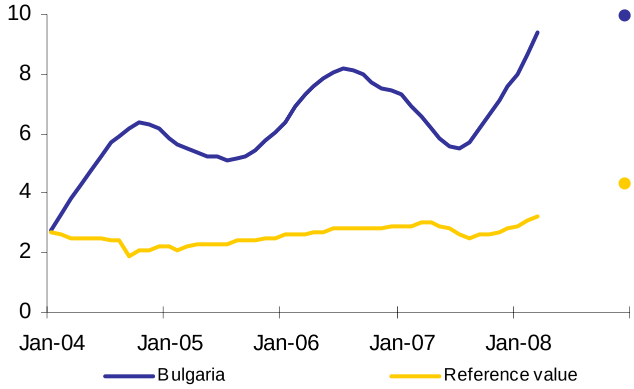
In Bulgaria, 12-month average inflation has been above the reference value since EU accession. The average inflation rate in Bulgaria during the 12 months to March 2008 was 9.4%, well above the reference value of 3.2%, and it is likely to remain well above the reference value in the months ahead.

HICP inflation in Bulgaria picked up significantly in recent years, with annual average inflation rising from 2.3% in 2003 to some 7½% in 2006 and 2007 and monthly year-on-year inflation reaching double digits in late 2007. Drivers of increasing inflation included higher energy and food prices and hikes in administered prices and excise duties, although underlying inflationary pressures also strengthened amid buoyant domestic demand and wage growth. Against this background, inflation is forecast to remain at elevated levels in the coming months, with annual average inflation rising to around 10% in 2008. Looking further ahead, a gradual decrease of inflation to some 6% is forecast in 2009 in line with an easing of demand pressures in the economy and the fading-out of the commodity price shock. The low price level in Bulgaria (45% of the EU average in 2006) suggests potential for price level convergence in the long term.

Bulgaria does not fulfil the criterion on price stability.

Graph 1a: **Bulgaria - Inflation criterion since 2004**

(percent, 12-month moving average)

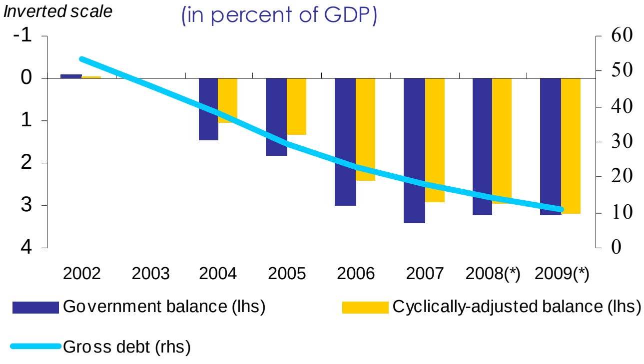


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

Bulgaria is not the subject of a Council Decision on the existence of an excessive deficit. Bulgaria's general government balance has improved markedly over the past several years, moving from a balanced position in 2003 to a surplus of 3.4% of GDP in 2007. While the total revenue-to-GDP ratio has been rising, expenditure as a share of GDP has been kept under restraint for most of the period. The general government gross debt ratio has followed a downward trend, from over 50% of GDP in 2002 to 18% of GDP in 2007. Based on a no-policy-change assumption, the Commission services' Spring 2008 Forecast expects the surplus to remain at around 3% of GDP in 2008 and 2009, while the debt ratio should remain on a decreasing path, reaching 11% of GDP in 2009.

Bulgaria fulfils the criterion on the government budgetary position.

Graph 1b: **Bulgaria - Government budget balance and debt**



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

The Bulgarian lev is not participating in ERM II. Since 1997, Bulgaria has pursued a currency board regime anchored to the D-Mark, and later the euro. The currency board arrangement has been instrumental to macroeconomic stabilisation and has been functioning smoothly since its introduction. Additional indicators do not point to pressures on the exchange rate during the assessment period, though investor risk perceptions seem to have heightened somewhat in the context of the recent global financial market turbulences, as indicated by a widening of short-term interest rate spreads vis-à-vis the euro area since late 2007. The currency board remains well-supported by official reserves, which increased robustly in recent years.

Bulgaria does not fulfil the exchange rate criterion.

The average long-term interest rate in Bulgaria in the year to March 2008 was 4.7%, below the reference value of 6.5%. Average long-term interest rates in Bulgaria have been below the reference value since EU accession. Long-term interest rates decreased significantly between 2003 and 2005, reflecting both a decline in global yields and a narrowing of spreads vis-à-vis the euro area. The latter virtually closed by end-2005, reflecting high investor confidence in Bulgaria's macroeconomic performance and prospects. Since mid-2006 spreads have opened up again, reaching some 80 basis points in March 2008, amidst increasing investor concern about the risks stemming from considerable macroeconomic imbalances.

Bulgaria fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Bulgaria's external deficit widened significantly in recent years, from 6% of GDP in 2004 to about 20% of GDP in 2007. The large external imbalance mainly reflects both consumption and investment expanding rapidly in the context of catching-up. Its size has clearly surpassed a level that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The external shortfall has been fully financed by foreign direct investment (FDI) inflows, amid positive investor sentiment. Given the high level of external debt, Bulgaria's external position implies significant financing needs in the medium-term. The Bulgarian economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Bulgaria does not fulfil the conditions for the adoption of the euro.

3. THE CZECH REPUBLIC

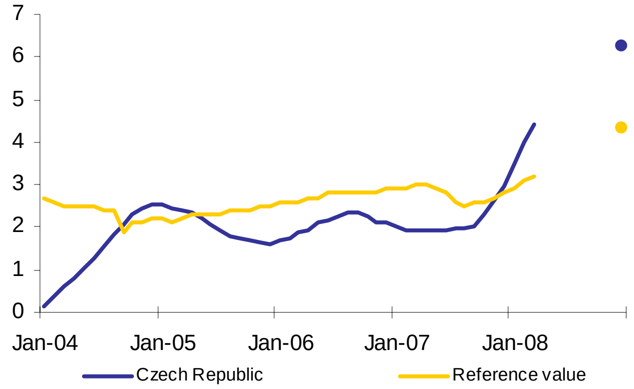
In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in the Czech Republic – notably the Act on the Czech National Bank (CNB) and the Act on the Financial Arbitrator – was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. The Act on the CNB was amended in 2007. However, the incompatibilities highlighted in the 2006 Convergence Report have not been addressed. As regards central bank integration into the ESCB at the time of euro adoption, the central bank's independence as well as the prohibition of monetary financing, the legislation in the Czech Republic, in particular the Act on the CNB and the Act on the Financial Arbitrator, is not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. The Act on the CNB contains imperfections related to the role of the ECB in the field of international cooperation, the role of the ECB and the EU in the collection of statistics and the appointment of external auditors, the promotion of the smooth operation of payment systems, the institutional and personal independence and the prohibition of monetary financing.

In the Czech Republic, 12-month average inflation has been above the reference value since December 2007. The average inflation rate in the Czech Republic during the 12 months to March 2008 was 4.4%, above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

Inflation in the Czech Republic, after having fluctuated around 2% since 2004, increased significantly in the second half of 2007 against the backdrop of rising energy and food prices. The rise in headline inflation occurred despite a further significant strengthening of the koruna, which has been on a sustained appreciation trend since 2004. During the first quarter of 2008, pushed up further by indirect tax changes and administered price increases, annual HICP inflation jumped to a nine-year high of almost 8%. The simultaneous rise in core inflation indices suggests that underlying domestic inflationary pressures have also increased. Inflation is likely to remain elevated for much of 2008, according to the Commission services' Spring 2008 Forecast, mainly due to the impact of higher commodity prices and one-off administrative measures, but it is forecast to decline sharply thereafter to below 3% on average in 2009 as these increases drop out of the calculation of annual rates. The relatively low price level in the Czech Republic (62% of the EU average in 2006) suggests potential for price level convergence in the long term.

The Czech Republic does not fulfil the criterion on price stability.

Graph 2a: **Czech Republic - Inflation criterion since 2004**
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

The Czech Republic is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004).[7] The Council recommended that Czech Republic take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2008 in a credible and sustainable manner. The Czech Republic's general government deficit has been reduced substantially since 2004. The general government deficit improved to 2.7% of GDP in 2006 and 1.6% of GDP in 2007. This is a result of better-than-expected revenues as well as some expenditure restraint. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will amount to 1.4% of GDP in 2008 and decrease slightly to 1.1% of GDP in 2009, while the general government debt is expected to decline from 28.1% of GDP in 2008 to 27.2% in 2009.

In view of these developments and the Commission services' Spring 2008 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the budget deficit below 3% of GDP. The Commission is therefore recommending that the Council abrogate the decision on the existence of an excessive deficit for the Czech Republic (SEC(2008) 571).

If the Council decides to abrogate the excessive deficit procedure for the Czech Republic, the Czech Republic will fulfil the criterion on the government budgetary position.

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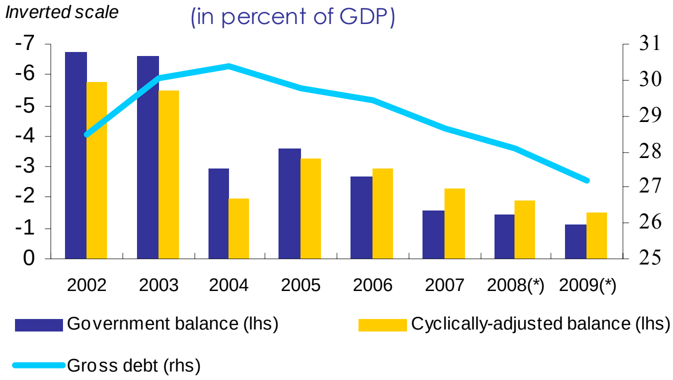
[7] 2005/185/EC, (OJ L 62, 9.3.2005, p. 20).

Graph 2b: **Czech Rep - Government budget balance and debt**

(in percent of GDP)



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

The Czech koruna is not participating in ERM II. The Czech Republic operates a floating exchange rate regime. During the two–year assessment period, the koruna appreciated against the euro by nearly 13%. The short-term volatility of the koruna appears to have reflected changes in global financial market conditions, though domestic factors have also been at play (e.g. developments in interest rate differential vis-à-vis major world currencies).

The Czech Republic does not fulfil the exchange rate criterion.

The average long-term interest rate in the Czech Republic in the year to March 2008 was 4.5%, below the reference value of 6.5%. Average long-term interest rates in the Czech Republic have been below the reference value since EU accession. Inflation expectations have been anchored at a low level and the appreciation of the koruna has contributed to keeping yields down. Long-term interest rates in the Czech Republic have moved close to or below the euro-area level since 2005, though the spread has turned slightly positive since the second half of 2007, mainly reflecting the diverging outlook for policy rates in the Czech Republic vis-à-vis the euro area and a decline in global risk appetite.

The Czech Republic fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. The external deficit in the Czech Republic narrowed significantly from around 6% of GDP in 2002-2004 to 1.6% of GDP in 2005, before widening to an average of around 2.6% in 2006-2007. The solid performance of the external balance was chiefly on account of a surge in merchandise exports, notably driven by foreign investment in manufacturing. The external deficit has been fully financed by net FDI inflows since EU accession. The Czech economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that the Czech Republic does not fulfil the conditions for the adoption of the euro.

4. ESTONIA

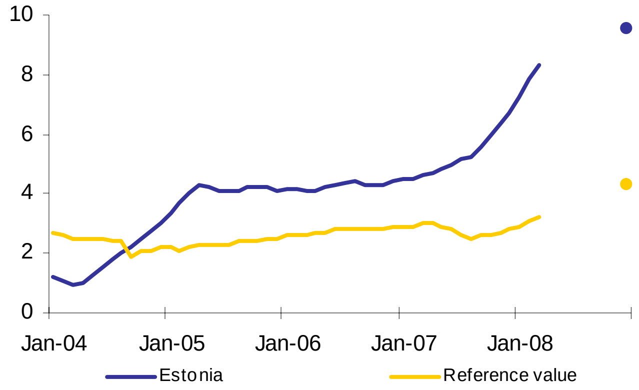
As stated in the 2006 Convergence Report, all legal incompatibilities raised in the 2004 Convergence Report have been removed. As regards central bank integration into the ESCB at the time of euro adoption, Article 111 of Estonia's Constitution is not formally compatible with the requirements of the EC Treaty and the ESCB/ECB Statute. However, the ruling of 11 May 2006 of the Constitutional Review Chamber of Estonia's Supreme Court provides legal clarity, in particular on the inapplicability of Article 111 after the introduction of the euro in Estonia. National legislation in Estonia can be considered compatible with the requirements of the Treaty and the ESCB/ECB Statute, subject to the repeal of the Currency Law and the Law on the Security of the Estonian Kroon with effect from the date of the introduction of the euro. The Eesti Pank Act contains, however, still some imperfections related to the Eesti Pank's integration into the ESCB for some banknote issues and the collection of statistics.

In Estonia, 12-month average inflation has been above the reference value since September 2004. The average inflation rate in Estonia during the 12 months to March 2008 was 8.3%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

HICP inflation in Estonia accelerated sharply in recent years, with annual average inflation rising to 6¾% in 2007 and monthly year-on-year inflation reaching double-digits in early 2008. Rising inflation reflected strong domestic demand growth and rising wage costs, compounded by significant food and energy price pressures. Inflation performance in the coming months will reflect continued upward pressures stemming from labour cost developments, higher energy and food prices as well as the impact of excise increases. Looking further ahead, a decline in inflation from 9½% in 2008 to 5% in 2009 is forecast, in line with a cooling economy and the fading out of one-off effects. The relatively low price level in Estonia (67% of the EU average in 2006) suggests potential for price level convergence in the long term.

Estonia does not fulfil the criterion on price stability.

Graph 3a: **Estonia - Inflation criterion since 2004**
(percent, 12-month moving average)



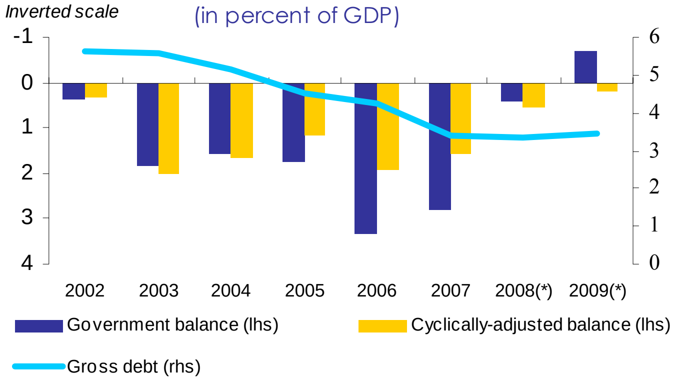
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

Estonia is not the subject of a Council Decision on the existence of an excessive deficit. Between 2002 and 2007, Estonia recorded an average general government surplus of some 2% of GDP. In 2007, Estonia recorded a general government surplus of 2.8%, compared to a peak of 3.4% one year earlier. The general government gross debt ratio stood at 3.4% of GDP in 2007, the lowest of all the EU Member States. The authorities have used the period of strong growth to build up considerable government reserves. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the surplus will drop significantly to 0.4% of GDP in 2008 and a deficit of 0.7% of GDP will emerge in 2009 on account of a sharply slowing economy. The debt ratio is forecast to stabilise around current levels in 2008 and 2009.

Estonia fulfils the criterion on the government budgetary position.

Graph 3b: **Estonia - Government budget balance and debt**

(in percent of GDP)



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

The Estonian kroon has participated in ERM II since 28 June 2004, i.e. for more than two years at the time of adoption of this report. Before ERM II entry, Estonia had pursued a currency board regime anchored to the D-Mark, and later the euro, since 1992. Upon ERM II entry, Estonia unilaterally committed to maintain its currency board in the mechanism. Additional indicators do not point to pressures on the exchange rate, though a rise in short-term interest rates in late 2007 has pointed to increased risk perceptions by markets. The currency board remains well-supported by official reserves. During the two-year assessment period, the kroon did not deviate from the central rate, and it did not experience severe tensions.

Estonia fulfils the exchange rate criterion.

As a result of Estonia's low level of government indebtedness, no benchmark long-term government bond or comparable security is available to assess the durability of convergence as reflected in long-term interest rates. On the basis of developments in an interest rate indicator based on kroon-denominated bank loans to households and non-financial businesses and taking into account, inter alia, the low level of government debt, there is no reason to conclude that Estonia would not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Estonia's external deficit has widened in recent years, increasing from around 10% of GDP on average between 2002 and 2005 to some 16% of GDP in 2007. While the emergence of the high external deficit can largely be attributed to transitional effects in a rapidly catching up economy, its size has clearly surpassed levels that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The external shortfall has to a significant extent been financed by intra-group bank lending. FDI inflows are sizeable but have more recently been partly outweighed by increased outward FDI. Given the high level of external debt, Estonia's external position implies significant financing needs in the medium term. The Estonian economy is highly integrated within the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Estonia does not fulfil the conditions for the adoption of the euro.

5. LATVIA

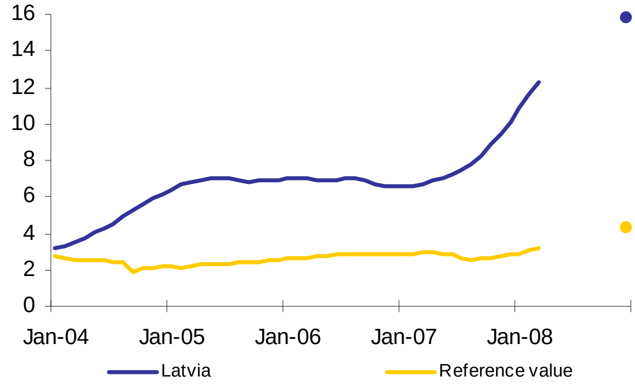
In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Latvia was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. The Law on the Bank of Latvia was amended in June 2006. No further amendments have been made since then. As regards central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition of monetary financing, the legislation in Latvia, in particular the Law on the Bank of Latvia, is not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute. Imperfections subsist as regards the objectives of the ESCB, the promotion of the smooth operation of payment systems, the statistical role of the ECB and the EU Council, the appointment of external auditors, the role of the ECB in the field of international cooperation, the institutional independence of the bank as well as the personal independence of the members of the Bank of Latvia’s decision-making bodies.

In Latvia, 12-month average inflation has been above the reference value since EU accession. The average inflation rate in Latvia during the 12 months to March 2008 was 12.3%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

In recent years, Latvia has experienced high and, since early 2007, rapidly increasing HICP inflation, reflecting sustained wage and demand pressures as well as the impact of external factors. Between EU accession in May 2004 and early 2007, HICP inflation moved in a range from 6 to 8%. However, in the course of 2007 headline HICP inflation accelerated sharply and reached more than 16% in the first quarter of 2008. Higher inflation partly reflected increases in administered prices and excises as well as global increases in energy and food prices. However, pressures from domestic sources, as evidenced by rising inflation for all main components of HICP except non-energy industrial goods, contributed importantly to the upsurge in inflation. Inflation is forecast to remain around the present elevated levels in 2008, averaging nearly 16% for the year, and to decelerate in 2009, albeit to a still relatively high level of around 8½%, in response to the expected economic slowdown and a fading-out of the impact of commodity price increases. The relatively low price level in Latvia (61% of the EU average in 2006) suggests potential for price level convergence in the long term.

Latvia does not fulfil the criterion on price stability.

Graph 4a: **Latvia - Inflation criterion since 2004**
(percent, 12-month moving average)

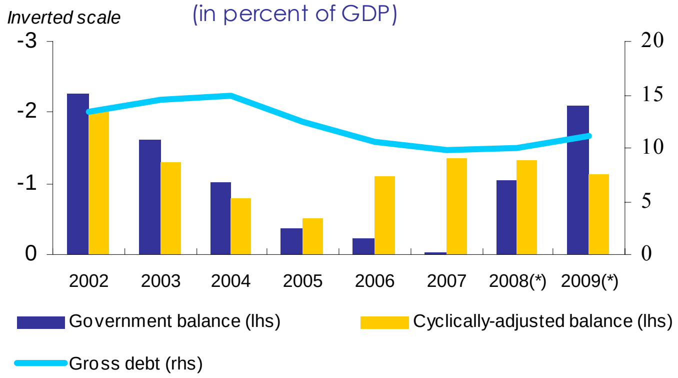


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

Latvia is not the subject of a Council Decision on the existence of an excessive deficit. Since 2002 the general government position has gradually improved to a balanced budget in 2007. The Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, projects a deterioration of the general government position in 2008 and 2009 as the economy slows down sharply, with a deficit of slightly above 2% of GDP expected for 2009. General government debt remained below 15% of GDP since the beginning of the decade, reached 9.7% of GDP in 2007, and is expected to increase only slightly in 2008 and 2009.

Latvia fulfils the criterion on the government budgetary position.

Graph 4b: **Latvia - Government budget balance and debt**
(in percent of GDP)



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

The Latvian lats has participated in ERM II since 2 May 2005, i.e. for more than 2 years at the time of adoption of this report. Before ERM II entry, Latvia operated an exchange rate peg, initially to the SDR basket (Special Drawing Rights), and from 1 January 2005 to the euro. Upon ERM II entry, Latvia unilaterally committed to keep the exchange rate of the lats within a ± 1% fluctuation band around the central rate. During the assessment period, the lats remained close to the central rate, and it did not experience severe tensions, although it incurred temporary episodes of financial market volatility. Until mid-February 2007 the lats traded close to the upper limit of the unilateral band with very limited fluctuations. In mid-February 2007, the exchange rate weakened suddenly against the euro in an episode of high market uncertainty and by end-March 2007 the lats was trading close to the lower limit of the unilateral ± 1% fluctuation band. However, subsequently the exchange rate strengthened again and mostly remained within the upper half of the fluctuation band, albeit with some short-term fluctuations. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates, do not reveal sustained pressures on the exchange rate, though a rise in the level of short-term interest rates relative to the euro area since early 2007 (reaching a peak at the end of 2007) has pointed to increased risk perceptions by markets.

Latvia fulfils the exchange rate criterion.

The average long-term interest rate in Latvia in the year to March 2008 was 5.4%, below the reference value of 6.5%. Average long-term interest rates in Latvia have been below the reference value since EU accession. The spread *vis-à-vis* euro area long-term benchmark bonds closed in the spring of 2006. Subsequently, however, long-term interest spreads to the euro area increased to around 120 basis points in March 2008 amidst increasing investor concern about the risks stemming from considerable macroeconomic imbalances.

Latvia fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Latvia's external deficit has soared in recent years, exceeding 10% of GDP since 2004 and widening to 20.9% of GDP in 2007. This has mainly reflected a shortfall in merchandise trade as imports were buoyed by strong domestic demand. While the emergence of the high external deficit can largely be attributed to transitional effects in a rapidly catching up economy, its size has clearly surpassed levels that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The deficit on the external balance has been mainly financed by inflows of other investment, largely linked to intra-group bank funding. Given the high level of external debt, the external position implies substantial financing needs in the medium term. The Latvian economy has become increasingly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a significant degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Latvia does not fulfil the conditions for the adoption of the euro.

6. LITHUANIA

As already concluded in the 2006 Convergence Report, legislation in Lithuania, in particular the Law on the Bank of Lithuania, is fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute.

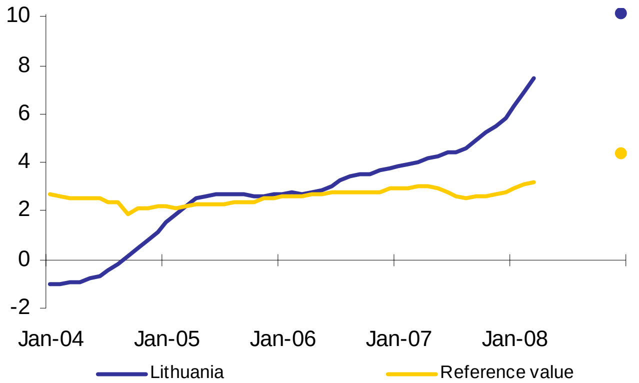
In Lithuania, 12-month average inflation has been above the reference value since April 2005, with the exception of April 2006 when it was at the reference value. The average inflation rate in Lithuania during the 12 months to March 2008 was 7.4%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

HICP inflation in Lithuania has been on an increasing trend since mid-2005, with inflation rising to 5.8% in 2007 and monthly year-on-year inflation reaching double digits in early 2008. The increase in inflation reflected a combination of factors including higher energy prices on world markets; increases in administered prices; and rising prices of unprocessed and processed food products, the latter most notably in 2007. Against the background of increasing pressure from the labour market and rising wage costs, the acceleration in inflation was also increasingly driven by demand factors, leading to a rapid increase in services prices.

A further significant increase in inflation is forecast in 2008, reflecting upward pressures from oil and agricultural prices, the feed-through of the large increase in prices of imported gas and excises taxes for tobacco, fuel and alcohol as well as rapid wage growth. Inflation is forecast to ease only gradually, from an annual average of about 10% in 2008 to about 7% in 2009, reflecting the lagged response of prices to the growth slowdown and moderation in oil and food prices. The relatively low price level in Lithuania (57% of the EU average in 2006) suggests potential for price level convergence in the long term.

Lithuania does not fulfil the criterion on price stability.

Graph 5a: **Lithuania - Inflation criterion since 2004**
(percent, 12-month moving average)



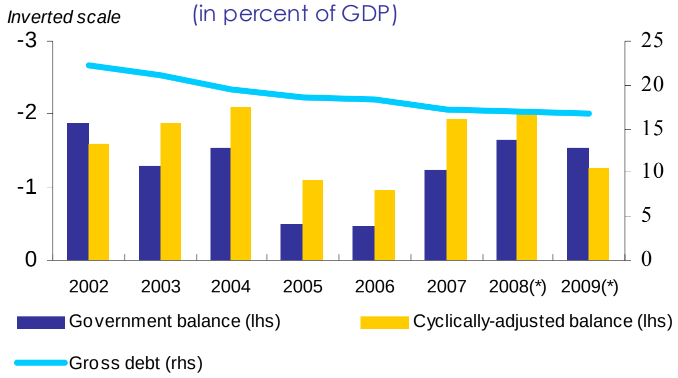
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

Lithuania is not the subject of a Council Decision on the existence of an excessive deficit. Fiscal consolidation efforts led to a decline of the deficit from around 2% of GDP in 2002 to 0.5% of GDP in 2005. Thereafter the budgetary deficit increased again and was 1.2% in 2007. The revenue ratio to GDP increased after 2004, mainly reflecting increasing inflows of EU funds, while the current primary expenditure ratio to GDP stayed relatively stable. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will widen further to 1.7% in 2008 and diminish only slightly to 1.5% in 2009. Lithuania's general government debt ratio declined steadily from 22.4% of GDP at the end of 2002 to 17.3% of GDP at the end of 2007, and it is expected to stabilise around this level in 2008 and 2009.

Lithuania fulfils the criterion on the government budgetary position.

Graph 5b: **Lithuania - Government budget balance and debt**

(in percent of GDP)



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

Lithuania has participated in ERM II since 28 June 2004, i.e. for more than 2 years at the time of adoption of this report. Before ERM II entry, the Bank of Lithuania operated a currency board as of April 1994, with the litas initially pegged to the US dollar and then re-pegged to the euro in February 2002. When entering ERM II, Lithuania unilaterally committed to maintain its currency board in the mechanism. During the assessment period, the litas did not deviate from the central rate, and it did not experience severe tensions. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates, do not point to pressures on the exchange rate, although increased risk perceptions by market participants have been reflected in a marked widening of short-term interest rates spreads vis-à-vis the euro area in the course of 2007, which largely reversed in early 2008.

Lithuania fulfils the exchange rate criterion.

The average long-term interest rate in Lithuania in the year to March 2008 was 4.6% percent, below the reference value of 6.5%. Average long-term interest rates in Lithuania have been below the reference value since EU accession. The spread vis-à-vis euro area long-term benchmark bonds, which had declined markedly in the run-up to ERM II entry in June 2004 and reached a low of about 20 basis points in mid-2007, started to increase thereafter to about 60 basis points at end-2007. This widening of spreads partly reflects a higher country risk premium amid increasing investor concern about the risks stemming from considerable macroeconomic imbalances.

Lithuania fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Lithuania's external deficit widened from 4.7% of GDP in 2001 to 12% of GDP in 2007, largely as a consequence of buoyant domestic demand. The main driver was a growing trade deficit in goods. While the pattern of an increasing external deficit is consistent with the rapid catching-up path of the economy, its size has clearly surpassed levels that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The deteriorating external balance was mainly financed by intra-group bank lending and to a lower extent by foreign direct investment. Given the sizeable external debt, Lithuania's external position implies significant financing needs in the medium-term. The Lithuanian economy is highly integrated with the EU. In particular, trade and FDI relations with other Member

States are extensive and the Lithuanian financial sector is substantially integrated into the broader EU financial sector, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Lithuania does not fulfil the conditions for the adoption of the euro.

7. HUNGARY

In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Hungary was not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute. The Act on the Magyar Nemzeti Bank (MNB) was amended in July 2007. Although some incompatibilities raised by the Convergence Report in 2006 have been removed, there are still many remaining. As regards central bank integration into the ESCB at the time of euro adoption, independence as well as the prohibition of monetary financing, existing Hungarian legislations, in particular the Act on the MNB, the Statutes of the MNB, the Constitution of Hungary and the Credit Institutions Act, are not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. Imperfections subsist as regards the objectives of the ESCB, banknotes and coins issues, the promotion of the smooth operations of payment systems, the statistical role of the ECB and the EU Council, the role of the ECB in the field of international cooperation, the absence of an obligation to comply with Eurosystem's financial reporting regime, the personal independence of the Governor and the prohibition of monetary financing.

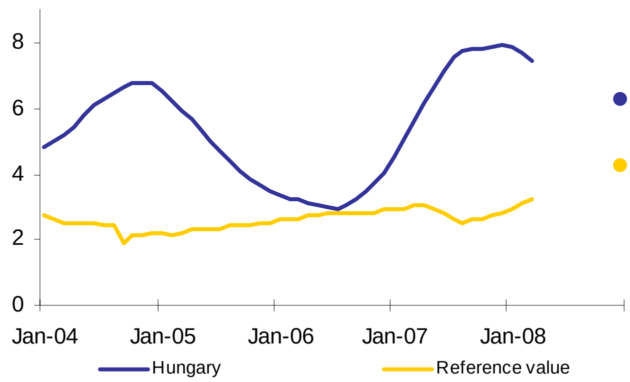
In Hungary, 12-month average inflation has been above the reference value since EU accession. The average inflation rate in Hungary during the 12 months to March 2008 was 7.5%, well above the reference value of 3.2%, and it is likely to remain well above the reference value in the months ahead.

Inflation has been very volatile in Hungary in recent years, mainly reflecting of the evolution of oil and food prices. Changes in administered prices and taxations have further amplified inflation volatility. These factors, compounded by the depreciation of the forint, led to a rapid increase in inflation from the second quarter of 2006. Inflation peaked at 9% in March 2007 and followed a downward trend until September 2007 reflecting lower inflation in unprocessed food and energy and an appreciating forint. Higher food price inflation led to a renewed increase in HICP inflation from the last quarter of 2007. Inflation averaged 7.9 % in 2007.

Reflecting high prices of food, oil, electricity and gas as well as the delayed impact of the depreciation of the forint in the second half of 2007 and in the beginning of 2008, inflation is forecast to remain elevated in 2008 at above 6%. Negative base effects for food and energy are forecast to lower inflation in 2009 to below 4%. The relatively low price level in Hungary (60% of the EU average in 2006) suggests potential for price level convergence in the long term.

Hungary does not fulfil the criterion on price stability.

Graph 6a: **Hungary - Inflation criterion since 2004**
(percent, 12-month moving average)

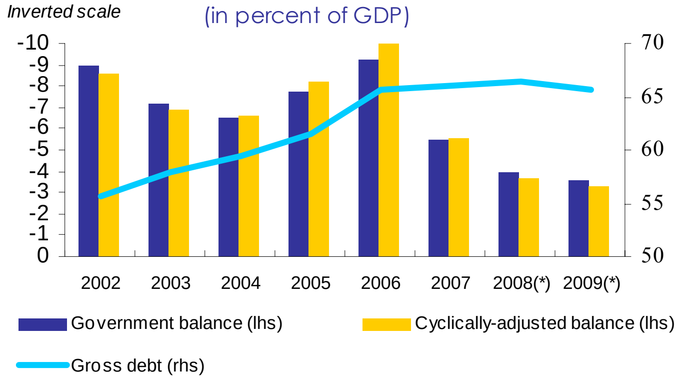


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

Hungary is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004)[8]. The Council recommended that Hungary take action in a medium-term framework in order to correct the excessive deficit by 2009 in a credible and sustainable manner. Thanks to the fiscal consolidation programme started in mid-2006, the budget deficit fell to 5.5% of GDP in 2007 from 9.2% in 2006. The expenditure ratio was somewhat reduced in 2007, while the revenue ratio benefited from measures addressing tax evasion. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will amount to 4% of GDP in 2008, followed by a slight improvement to 3.6% of GDP in 2009. Due to the continued fiscal loosening until mid-2006, the debt-to-GDP ratio significantly increased and reached around 66% in 2007. The Commission services' Spring 2008 Forecast projects general government debt to remain around present levels in 2008 and 2009.

Hungary does not fulfil the criterion on the government budgetary position.

Graph 6b: **Hungary - Government budget balance and debt**
(in percent of GDP)



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

The Hungarian forint is not participating in ERM II. The forint was unilaterally pegged to the euro with a ± 15 % fluctuation margin between 2001 and February 2008, when the exchange rate bands were abolished and a free-floating exchange rate

8 2004/918/EC, (OJ L 389, 30.12.2004, p. 27).

regime was adopted. Between August 2005 and August 2006, the forint depreciated substantially vis-à-vis the euro in response to growing concerns about the fiscal situation. The forint reached a low point in June 2006, after which it gradually strengthened. The strengthening path reversed in mid-2007, mainly reflecting increased risk aversion vis-à-vis emerging markets and increased concerns about the Hungarian economic situation, but the exchange rate started to appreciate again in March 2008. During the two-year assessment period, the forint appreciated against the euro by about 4.5%.

Hungary does not fulfil the exchange rate criterion.

The average long-term interest rate in Hungary in the year to March 2008 was 6.9%, above the reference value of 6.5%. Average long-term interest rates in Hungary have been above the reference value since EU accession. Bond yield spreads with the euro area widened to approximately 400 basis points in October 2006 reflecting mounting investors' worries about fiscal slippages, and gradually decreased thereafter. They started to widen again in November 2007 and reached about 400 basis points in early 2008, in a context of lower global risk appetite and concerns about the domestic economic situation.

Hungary does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. The Hungarian external deficit reached a peak of 8.1% of GDP in 2004 and gradually decreased thereafter reflecting buoyant export growth. In 2007, it further decreased to 4% of GDP due to weaker domestic demand. The substantial external deficits in recent years were mainly financed by FDI and portfolio inflows, although in 2007 banks' external borrowing was the main source of financing, as one-off factors led to a sharp fall in FDI and portfolio inflows. Given the high level of external debt, a return to larger external deficits would imply substantial financing needs in the medium term. The Hungarian economy is highly integrated within the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU financial sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Hungary does not fulfil the conditions for the adoption of the euro.

8. POLAND

In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Poland – notably the Constitution of Poland, the Act on the National Bank of Poland (NBP) and the law on the Bank Guarantee Fund – was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. In January 2007, an amendment was made to the Act on the NBP. However, it did not address any of the incompatibilities highlighted in the 2006 Convergence Report. As regards central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition of monetary financing, the objectives of the monetary policy, the legislation in Poland is not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute. Several imperfections subsist as regards the reference to the objectives of the ESCB, the statistical role of the ECB and EU Council, the role of the ECB in the field of international cooperation, the role of the ECB and the EU in appointing the external auditor, the role of the ECB in the functioning of payment systems, the obligation to consult the ECB for certain acts and the personal independence of the NBP's decision-making bodies.

In Poland, 12-month average inflation was below or at the reference value from November 2005 until February 2008. The average inflation rate in Poland during the 12 months to March 2008 was 3.2%, at the reference value, and it is likely to move slightly above the reference value in the months ahead.

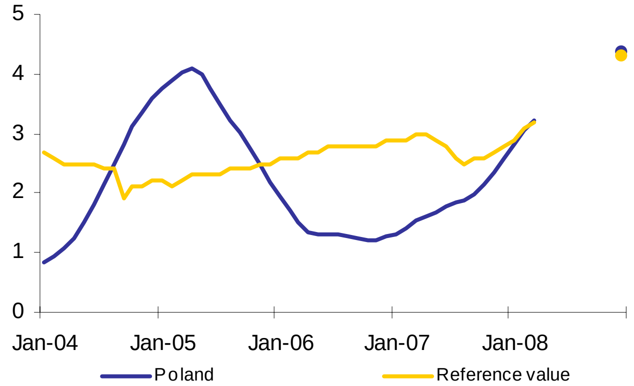
Following high and volatile inflation in the 1990s, HICP inflation in Poland decreased sharply to a very low level, averaging around 2% over the period 2002-2006. The sustained strengthening trend of the zloty since 2004 has exerted a significant moderating effect on inflation over recent years. However, HICP inflation picked up strongly in the course of the second half of 2007 on the back of rising food and energy prices, though buoyant domestic demand contributed to price pressures across a wide range of categories. Annual headline HICP inflation reached 4.5% in the first quarter 2008, which was the highest level since end-2004.

HICP inflation is likely to remain at elevated levels for much of 2008, according to the Commission services' Spring 2008 Forecast. This reflects mainly the impact of higher commodity prices, some of them being passed through with a lag (for instance to consumer gas and electricity prices), and demand pressures stemming from buoyant wage and credit growth. Annual inflation is forecast to decline slightly thereafter from 4.3% in 2008 to 3.4% in 2009, as the one-off price hikes drop out of the calculation of annual rates. This profile for inflation also hinges on the assumption that that second-round effects from temporary factors affecting current headline inflation will remain broadly contained in a context of increasing capacity utilisation and a tightening labour market. The relatively low price level in Poland (62% of the EU average in 2006) suggests potential for price level convergence in the long term.

Sustainable convergence implies that respect of the reference value reflects underlying fundamentals rather than temporary factors. In the case of Poland, the moderating influence of the appreciating exchange rate on inflation represents an important temporary factor, and average annual inflation is expected to soon rise above the reference value.

Poland does not fulfil the criterion on price stability.

Graph 7a: **Poland - Inflation criterion since 2004**
(percent, 12-month moving average)



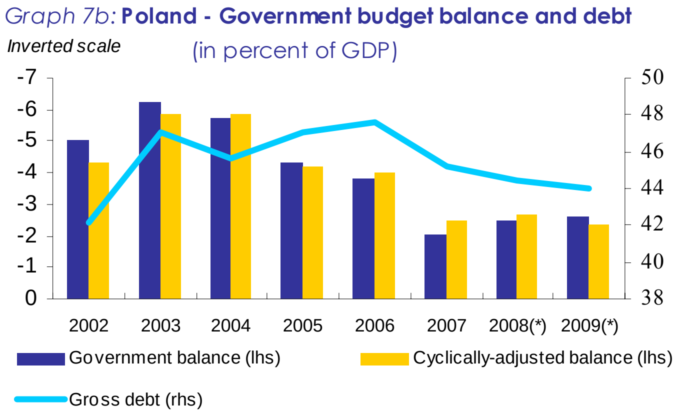
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

Poland is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004)[9]. The Council recommended that Poland take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2007 in a credible and sustainable manner. Poland's general government deficit has been reduced substantially since 2004. The deficit-to-GDP ratio was 2.0% in 2007 and according to the Commission services' Spring 2008 Forecast will amount to around 2½% of GDP in both 2008 and 2009 under a no-policy-change assumption. General government debt reached 45.2 of GDP in 2007. The Commission services' Spring 2008 Forecast projects a slight reduction of the general government debt ratio in 2008 and 2009.

At the end of 2007 the Commission and the Council invited the Polish authorities to submit a new convergence programme update describing their medium-term budgetary strategy for the whole legislature geared towards confirming a durable correction of the excessive deficit in 2007 and making progress towards the medium-term objective thereafter. The Polish authorities submitted a new convergence programme update at the end of March 2008. At the time of preparing this report, the Commission is assessing this programme. In the light of this assessment and the Commission services' Spring 2008 Forecast, the Commission could recommend the abrogation of the excessive deficit procedure.

Poland does not fulfil the criterion on the government budgetary position.

9 2005/183/EC, (OJ L 62, 9.3.2005, p. 18).



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

The Polish zloty is not participating in ERM II. Poland operates a floating exchange rate regime. During the two-year assessment period, the zloty appreciated by nearly 13% against the euro. The short-term volatility of the zloty appears to have reflected predominantly changes in global financial market conditions such as reversals in risk appetite, though domestic factors have also been at play (e.g. recent widening of short-term spread vis-à-vis the euro).

Poland does not fulfil the exchange rate criterion.

The average long-term interest rate in Poland in the year to March 2008 was 5.7%, below the reference value of 6.5%. Average long-term interest rates in Poland have been below the reference value since January 2006. A decreasing country-risk premium, the appreciation of the zloty and a positive perception among investors about the prospects for the Polish economy helped keep yields down. With the fall in inflation and monetary policy rates in 2005, the positive long-term interest spreads vis-à-vis the euro area fell and then hovered at just above 100 basis points, although the spread has widened since mid-2007, reflecting notably the diverging outlook for policy rates in Poland relative to the euro area and a decline in global risk appetite.

Poland fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Poland's external deficit slightly deteriorated, to around 2.6% of GDP in 2007, after bottoming out at 0.9% of GDP in 2005, largely due to a worsening in the trade balance as imports were buoyed by strong domestic demand. Net FDI inflows have increased substantially since EU accession, though from a lower level compared to other new Member States, and are providing sufficient financing for external deficits. The Polish economy is increasingly integrated within the EU. In particular, trade and FDI relations with other Member States are growing, and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Poland does not fulfil the conditions for the adoption of the euro.

9. ROMANIA

Romania joined the European Union on 1 January 2007. In this report, the compatibility of its legislation with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute and its progress towards the achievement of sustainable economic convergence are therefore assessed for the first time.

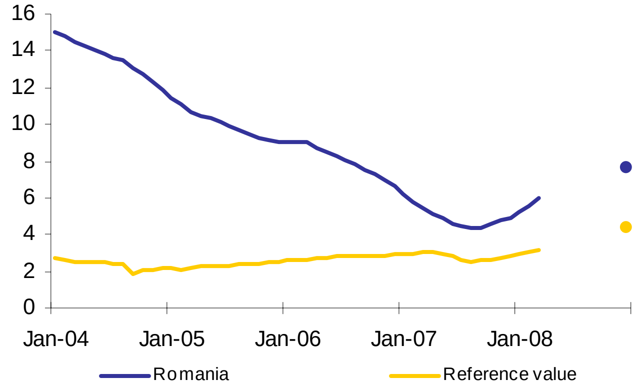
The legal basis for the Banca Națională a României (BNR) is set out in the Law No 312 of 28 June 2004 on the Statute of the BNR. This Law entered into force on 30 July 2004 and has not been amended since then. As regards central bank integration into the ESCB at the time of euro adoption, its independence as well as the prohibition of monetary financing, the legislation in Romania, in particular the Law on the Statute of the BNR, is not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute. Imperfections subsist as regards the reference to the objectives of the ESCB, institutional and personal independence, the ECB's right to be consulted in its fields of competence, the promotion of the smooth operation of payment systems, the statistical role of the ECB and of the EU Council and their role in the appointment of an external auditor.

In Romania, 12-month average inflation has been above the reference value since EU accession. The average inflation rate in Romania during the 12 months to March 2008 was 5.9%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

Inflation in Romania recorded a sustained downward trend for a number of years until 2006, supported *inter alia* by an appreciation of the leu since 2004. Headline HICP inflation reached a minimum of slightly below 4% in early 2007 but increased markedly afterwards partly driven by a sharp upward movement in agricultural prices, which reflected both the severe drought in the summer of 2007 and trends in world market prices. Persistent wage and demand pressures, increases in fuel prices and the significant weakening of the leu from the second half of 2007 added to the pick-up in inflation. HICP inflation averaged 4.9% in 2007 and is projected to increase markedly in 2008, to slightly below 8% on average, before decelerating in 2009 to close to 5% as the inflationary impact of commodity price increases fades. The relatively low price level in Romania (57% of the EU average in 2006) suggests potential for price level convergence in the long term.

Romania does not fulfil the criterion on price stability.

Graph 8a: **Romania - Inflation criterion since 2004**
(percent, 12-month moving average)



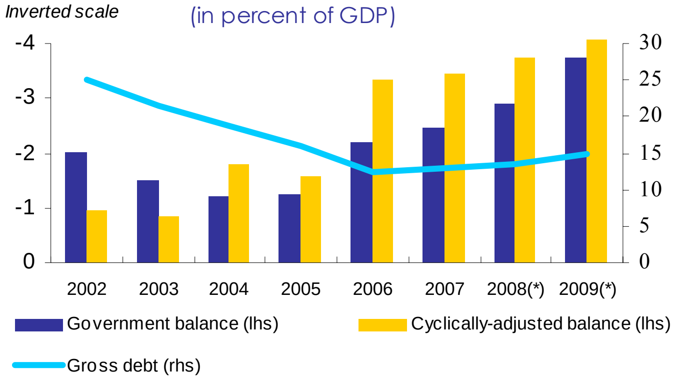
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

Romania is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance has deteriorated significantly over the last two years, with the deficit rising from 1.2% of GDP in 2005 to 2.5% of GDP in 2007. Both the revenue- and expenditure-to-GDP ratios have gradually increased in the past few years. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the general government balance will deteriorate slightly to a deficit of just below 3% of GDP in 2008, followed by a further increase to 3.7% in 2009. General government debt declined from 25% of GDP in 2002 to 13% of GDP in 2007, with modest increases foreseen for 2008 and 2009.

Romania fulfils the criterion on the government budgetary position.

Graph 8b: **Romania - Government budget balance and debt**

(in percent of GDP)



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

The Romanian leu is not participating in ERM II. Romania operates a floating exchange rate regime. From late 2004 to the beginning of July 2007, the exchange rate of the leu experienced a strong appreciation against the euro and other major currencies, supported by inflows of foreign capital and a positive investor sentiment. The start of turbulences on world financial markets in the summer of 2007 marked the beginning of a substantial weakening of the leu exchange rate. In recent years official reserves have shown a trend increase, and until mid-2007 exchange rate appreciation went hand in hand with narrowing money market interest rate differentials vis-à-vis the euro area. The reversal in the exchange rate in summer 2007 was accompanied by a marked widening of the 3-month interest rate spread.

Romania does not fulfil the exchange rate criterion.

Average long-term interest rates in Romania have been above the reference value since EU accession. The average long-term interest rate in Romania in the year to March 2008 was 7.1%, above the reference value of 6.5%. After EU accession, long-tem bond yield spreads against the euro area initially declined, but widened again in the second half of 2007 in the wake of global financial turmoil which prompted a decrease in risk appetite.

Romania does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Romania's external deficit has risen sharply in recent years, mainly reflecting a shortfall in merchandise trade as imports were buoyed by strong domestic demand. The external deficit widened from 7.5% of GDP in 2004 to slightly above 13% of GDP in 2007. While the pattern of an increasing external deficit is consistent with the rapid catching-up path of the economy, its size has clearly surpassed levels that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The sharp widening in the external deficit has led to a marked increase in foreign liabilities, implying higher financing costs in the medium term. Whereas until 2006 the external deficit was largely covered by FDI, sizeable inflows of other investment (largely linked to intra-group bank funding) gained in importance in 2007. The process of trade integration with the EU is well under way, but Romanian exports are concentrated in rather low-technology segments. The Romanian financial sector is substantially integrated into the broader EU financial sector, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Romania does not fulfil the conditions for the adoption of the euro.

10. SLOVAKIA

In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Slovakia, in particular the Act on the National Bank of Slovakia (NBS) and the Law on the protection of bank deposits and on amendments to certain laws, was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. Incompatibilities existed regarding the legal integration into the ESCB and the prohibition of monetary financing. In order to address these issues and to ensure full compatibility with the Treaty and the ESCB/ECB Statute, the Act on the NBS was amended. The revised Act on the NBS was adopted by the Parliament on 28 November 2007 and signed by the President of the Slovak Republic on 14 December 2007. All incompatibilities raised in the Convergence Report of 2006 have been removed. Legislation in Slovakia, in particular the Act on the National Bank of Slovakia and the Law on the protection of bank deposits and on amendments to certain laws, is now fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute.

In Slovakia, 12-month average inflation has been at or below the reference value since August 2007. The average inflation rate in Slovakia during the 12 months to March 2008 was 2.2%, well below the reference value of 3.2%, and it is likely to remain below the reference value in the months ahead, albeit with a narrowing margin.

In recent years, Slovakia has experienced volatile, and at times high, HICP inflation, reflecting the impact of external factors and adjustments in administered prices and indirect taxes. Adjusted for the impact of administered price increases, developments in underlying inflation have on the whole been favourable. The koruna's trend exchange rate appreciation since 2002 has exerted a moderating effect on inflation, in particular in 2007 and early 2008, following the large appreciation between mid-2006 and spring 2007 (14% in effective terms).

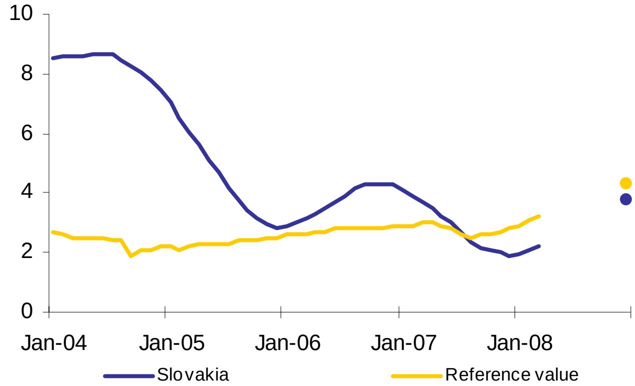
The stronger exchange rate of the koruna combined with low increases in regulated energy prices and fuel prices contributed to a decrease in annual HICP inflation to a historical low of 1.2% in summer 2007. Inflation subsequently increased to 3.4% in the first quarter of 2008, mostly as a result of the global shocks affecting food and fuel prices, but also due to some acceleration in prices of non-regulated services. These factors are expected to raise inflation further in the coming months, leading to an annual average rate around 3¾% in 2008. Average inflation is forecast to decline to some 3¼% in 2009. Favourable base effects at the end of 2008, related to the assumed lower increases in commodity prices, and the further exchange rate appreciation in the first quarter of 2008 should more than offset the delayed impact of higher excise duties on tobacco and the fading away of the disinflationary impact of the exchange rate appreciation in 2006-2007, thus supporting a return to lower inflation rates towards the end of the year. The tightening labour market and strong cyclical position (with the possibility of an acceleration in household demand and wages) as well as possible higher increases in administered prices represent risks to the medium-term inflation outlook. The relatively low price level in Slovakia (58% of the EU average in 2006) suggests potential for price level convergence in the long term.

Sustainable convergence implies that respect of the reference value reflects underlying fundamentals rather than temporary factors. In the case of Slovakia, the moderating influence of the appreciating exchange rate on inflation represents an important temporary factor. However, the analysis of underlying fundamentals and the fact that the reference value is met by a wide margin support a positive assessment on the fulfilment of the price stability criterion.

Slovakia needs to be vigilant to protect the low inflationary environment and a favourable competitiveness position. In particular, wage discipline will have to continue after the productivity upswing related to FDI inflows has subsided, and advancing structural reforms to improve the functioning of product markets is warranted with a view to strengthening the competitive environment. A more ambitious fiscal policy stance would also help to mitigate risks to inflation. With a view to keep inflation in check after possible euro adoption , the Slovak government and social partners signed in early 2008 the Declaration of Social Agreement to Adopt and Use the Euro in Slovakia, which commits employers and trade unions to keep wage growth in line with productivity growth. Furthermore, the government adopted other policy commitments, such as reaching a balanced general government budget by 2011 and tightening the fiscal stance further in case of unexpected inflationary pressures, as well as a set of structural measures. However, these policy commitments need to be translated into action.

Slovakia fulfils the criterion on price stability.

Graph 9a: **Slovakia - Inflation criterion since 2004**
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

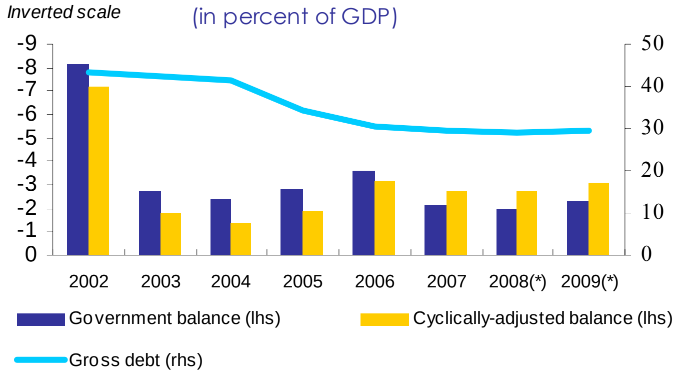
Slovakia is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004).[10] The Council recommended Slovakia to take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2007 in a credible and sustainable manner. Slovakia's general government deficit has been reduced substantially since 2002. Both the revenue- and expenditure-to-GDP ratios have decreased, the latter at a higher rate. The deficit-to-GDP ratio was 2.2% in 2007 and according to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, it will amount to 2.0% of GDP in 2008, followed by a moderate widening to 2.3% in 2009. General government debt declined significantly since the beginning of the decade to reach 29.4% of GDP in 2007. The Commission services' Spring 2008 Forecast projects a general government debt ratio of 29.2% of GDP for 2008 and 29.7% in 2009.

In view of these developments and the Commission services' Spring 2008 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the budget deficit below 3% of GDP. The Commission is therefore recommending that the Council abrogate the decision on the existence of an excessive deficit for Slovakia (SEC(2008) 572).

If the Council decides to abrogate the excessive deficit procedure for Slovakia, Slovakia will fulfil the criterion on the government budgetary position.

[10] 2005/182/EC, (OJ L 62, 9.3.2005, pp. 16-17).

Graph 9b : **Slovakia - Government budget balance and debt**



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

The Slovak koruna has participated in ERM II since 28 November 2005, i.e. for more than 2 years at the time of adoption of this report. Before ERM II entry, Slovakia operated a managed floating exchange rate regime. After ERM II entry, the koruna continued its pre-ERM II appreciation trend. The steady appreciation was interrupted in the second quarter of 2006 when the koruna temporarily weakened due to post-election uncertainties about prospects for fiscal policy, combined with broader pressures on the central European currencies. Strong appreciation between July 2006 and March 2007 led to a revaluation of the central parity of the koruna by 8.5% with effect from 19 March 2007. Following the revaluation, the koruna exchange rate moved between 3% and 7.3% above the new central parity until January 2008 when renewed appreciation pressures pushed the koruna up to 8-9% above the ERM II central parity in March-April. During the two-year assessment period, the koruna traded almost always in the stronger part of the fluctuation band, with an average deviation of 5.4% from the central parity. The appreciation within ERM II over the assessment period can be considered as consistent with underlying fundamentals and the koruna did not experience severe tensions.

Slovakia fulfils the exchange rate criterion.

The average long-term interest rate in Slovakia in the year to March 2008 was 4.5 percent, below the reference value of 6.5 percent. Average long-term interest rates in Slovakia have been below the reference value since EU accession. The spread vis-à-vis euro-area long-term benchmark bonds had been declining markedly since 2002 to practically disappear in April 2007. The factors behind this trend were decreasing country-risk premia linked to fiscal consolidation and far-reaching structural reforms in 2002-2005, and more recently the benign inflation outlook and associated reduction in short-term policy rates. Since mid-2007, a slight positive spread of around 30 basis points opened again reflecting the significant drop in long-term interest rates in the euro area.

Slovakia fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Slovakia's external balance has been highly volatile in recent years reflecting swings in export performance driven by new FDI-related production capacities, in particular in the automotive and electronic equipment sector. Following a substantial deterioration from 0.8% of GDP in 2003 to above 8% of GDP in 2005-2006 on account of dynamic private consumption and an increase in FDI-related imports, the external deficit narrowed back to 5.3% of GDP in 2007 as export performance was boosted by the launch of production in new FDI-financed capacities. The external deficit has been mainly financed by large net FDI inflows. The Slovak economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a significant degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, taking into account the additional factors, and assuming that the Council will follow the Commission's recommendation for the abrogation of the excessive deficit, the Commission considers that Slovakia fulfils the conditions for the adoption of the euro.

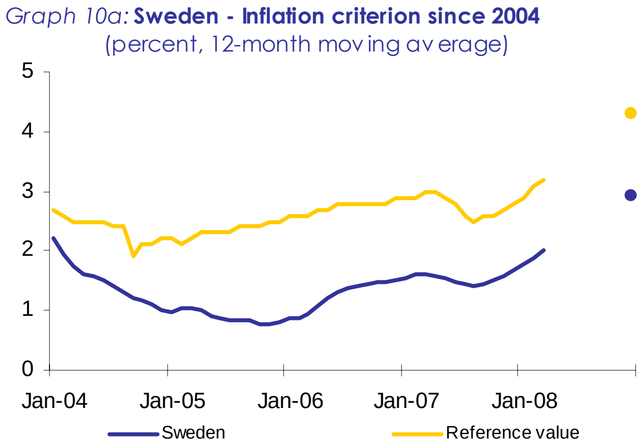
11. SWEDEN

In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Sweden was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. The Sveriges Riksbank Act was amended in 2006 and 2007, without addressing the incompatibilities highlighted in the 2006 Convergence Report. As regards the independence of the central bank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the Sveriges Riksbank Act, the Instrument of Government (part of the Swedish Constitution) and the Law on the Exchange Rate Policy, is not fully compatible with Articles 108 and 109 of the EC Treaty and the ESCB/ECB Statute. Several imperfections subsist as regards the objectives of the Sveriges Riksbank, the promotion of the smooth operation of payment systems, the prohibition of monetary financing, the role of the ECB in the functioning of the payment systems and in the field of international cooperation, the statistical role of the ECB and of the EU and their role in the appointment of external auditors.

In Sweden, 12-month average inflation has been below the reference value since the start of monitoring in December 1996. The average inflation rate in Sweden during the 12 months to March 2008 was 2.0%, well below the reference value of 3.2%, and it is likely to remain well below the reference value in the months ahead.

HICP inflation in Sweden recorded a downward trend until late 2005 but has picked up since then. Falling HICP inflation until late 2005 was mainly related to high productivity growth, underpinned by a cyclical component as well as by the impact of extensive investment in information technology. A second contributing factor was lower import prices, due to the gradual pass-through of the strengthening of the krona between 2002 and 2004 and increased international competition. The upward dynamics since late 2005 has mainly reflected higher oil and electricity prices. In addition, food prices have contributed to higher inflation during the last part of 2007, in line with overall global developments. Inflation is forecast to decline from 2.4% in 2008 to around 1.9% in 2009.

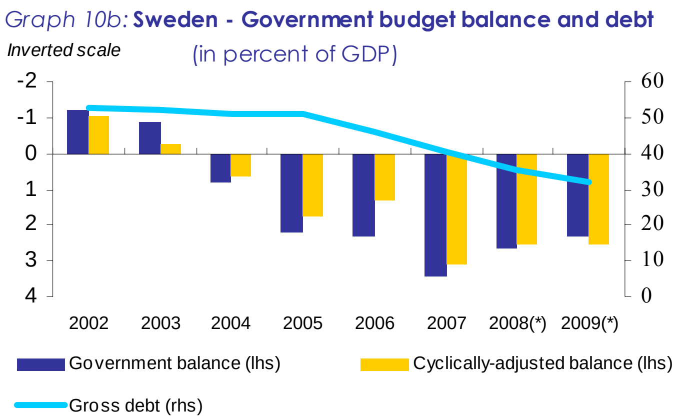
Sweden fulfils the criterion on price stability.



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

Sweden is not the subject of a Council decision on the existence of an excessive deficit. Over the period 2002-2007, the budgetary position of Sweden improved steadily, with the general government balance moving from a deficit of about 1% of GDP in 2002 to a surplus of 3.5% in 2007, partly due to the cyclical recovery of the economy. The revenue ratio remained stable at around 55% of GDP, while the share of expenditure to GDP has gradually decreased (from 56.5% in 2002 to 52.5% in 2007). In line with the favourable fiscal development, the government gross debt has fallen from 52.6% of GDP in 2002 to 40.6% in 2007. Based on a no-policy-change assumption, the Commission services' Spring 2008 Forecast projects a decrease of the general government surplus to above 2% of GDP in 2008 and 2009, while the debt ratio will remain on a declining path, reaching 32% of GDP in 2009.

Sweden fulfils the criterion on the government budgetary position.



(*) Commission services' Spring 2008 Forecast.
Source: Eurostat, Commission services.

The Swedish krona is not participating in ERM II. Sweden has pursued a floating exchange rate regime and inflation targeting since the early 1990s. After a sharp depreciation following the abandonment of the pegged system in 1992, the krona has moved in a relatively narrow range vis-à-vis the Deutsche mark and subsequently the euro. During the two-year assessment period, the krona has been between 9 and 9.50 SEK/EUR, averaging above 9.2 SEK/EUR.

Sweden does not fulfil the exchange rate criterion.

In March 2008, the twelve-month moving average of the Swedish ten-year benchmark bond was 4.2%, below the reference value of 6.5%. Average long-term interest rates have been consistently below the reference value in recent years. The spread vis-à-vis euro-area long term interest rates declined gradually from around 50 basis points in 2003 to -25 basis points in mid-2007. Subsequently, in line with a closing short-term interest rate gap, the negative spread between the Swedish and euro-area long term interest rate narrowed gradually to its present level of around zero.

Sweden fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. The Swedish external account has been in surplus since the mid-1990s, driven by high net exports in goods and to a lesser extent in services. The external account surplus has increased from 4.9% of GDP in 2002 to a level of around 6-7% of GDP during the last years. The Swedish economy is open and well integrated within the EU, with a share of intra-EU trade in goods around two thirds on both the export and import side. The relative importance of intra-EU trade in services has slightly increased over the period and is above the average for the EU-27. The integration of Sweden's financial sector into the broader EU sector relates mainly to links with other Nordic States and the Baltic States. Sweden’s financial sector is overall very well developed, both in size and sophistication, and corresponds to its advanced stage of economic development.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Sweden does not fulfil the conditions for the adoption of the euro.